

Letter of Comment No: 67
File Reference: 1101-001
Date Received: 11/8/02



National Venture Capital Association

November 4, 2002

VIA E-MAIL AND OVERNIGHT COURIER

Financial Accounting Standards Board
MP&T Director – File Reference 1101-001
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Sir or Madam:

On behalf of the National Venture Capital Association, I am writing to offer comments on the Proposed Statement of Financial Accounting Standards, *Accounting for Stock-Based Compensation -- Transition and Disclosure (an amendment of FASB Statement No. 123)*, dated October 4, 2002 (the “Exposure Draft”). The NVCA has been actively involved in the stock option debate from the beginning and we appreciate the opportunity to express our views to the Board.

Proposed Amendments to Disclosure Provisions

More prominent and consistent display of information relating to employee stock options is appropriate. As a result, we agree with the Board’s proposal to include stock option information in a more prominent location in the financial statements. The “Summary of Significant

Accounting Policies” is one appropriate location for the disclosures.¹ As an alternative, we believe that the investing public might be even better served by including all relevant stock option information in a separate, easy to read schedule.

We vehemently disagree, however, with the Board’s proposal to disclose stock option information using the “fair value method” of FASB Statement No. 123 each quarter. First, it implies that stock options are, in fact, a form of compensation. In general, the NVCA agrees that stock options can be compensation where there is an explicit exchange of options for cash or other direct forms of payment. But that is seldom the case in practice. Most grants are unilateral, and not explicit exchanges of value. Many employers grant options to all employees. There is no bargaining. In the absence of options, few companies would pay the majority of their option recipients more.

Second, and a point with which everyone can agree, recognition of any expense item is appropriate only when the value of the exchange can be measured with sufficient reliability and in a manner that promotes comparability between companies. Simply being valuable is not enough to justify a charge; that value has to be measurable.

Existing option-pricing models use complicated formulas based on numerous assumptions, including predictions of interest rates, dividend expectations, and stock volatility 10 years into the future. The same model can produce widely divergent results depending upon what guesses the company decides to use. There simply has been no agreement in accounting circles

¹ As noted in the Exposure Draft, APB Opinion No. 22, *Disclosure of Accounting Policies*, paragraph 15, expresses a preference for disclosure of significant accounting policies either before the notes to the financial statements or as the initial note.

regarding option-pricing models for employee stock options since the current accounting rules for options were adopted in 1972. In short, although the Board believed that option pricing models that were developed to value a freely tradeable stock option could be used to value a very different instrument – an employee stock option that is not freely tradeable and which vests over time – the historical data that has developed over the last seven years proves otherwise. The shortcomings of these models are compounded by the fact that FASB Statement No. 123 does not allow adjustments to be made when options expire unexercised or when reality turns out to be nothing like it was projected at the time the expense amount was determined. For example, the Wall Street Journal has reported that “[a]n estimated seven to 10 million Americans hold employee stock options, according to the National Center for Employee Ownership. The value of options on the date they were granted approaches \$25 billion for the top 200 companies in the Fortune 500, says compensation-consulting firm Pearl Meyers & Partners, based on its annual survey. Corey Rosen, executive director for the nonprofit National Center for Employee Ownership, estimates that ‘maybe as much as half [of those options] currently are underwater’ because of the stock-market declines since early 2000.” Workers to Bear Brunt of Push for Firms to Expense Options, Wall Street Journal, August 7, 2002

The minimum value approach allowed for non-public companies under FASB Statement No. 123 addresses this issue to some extent by assuming that stock price volatility is zero. This is clearly more appropriate for the pre-public companies that NVCA represents than requiring such companies to predict stock price volatility when there is no active market for the stock. However, even this method grossly overstates the value of any employee stock options because it does not allow any discount for lack of transferability and also does not allow an expense to be

adjusted to reflect actual option activity. With this said, we continue to believe that current option pricing models, including the minimum value model, simply are too unreliable to be used.

Some have argued that disclosing some number is better than disclosing no number at all. We disagree. Disclosure of a specific expense figure implies that there is some certainty associated with that number and that is reliable. This is not the case with employee stock option “fair value” computations. Indeed, because of all of the predictions into the future that are required by current option pricing models, a company could come up with wildly different estimates of value using just a single model and be able to justify each one of them. Trying to value employee stock options is a little like the old joke about asking a CPA how much two plus two equals – anything you want.

For companies that do not issue many options, this may not be of particular concern because it may not represent a material item and may not materially distort the financial statements. But to many companies that rely heavily on options, the distortion would be material. It is well known that this is true for the tech community. But it is also true for the companies that the NVCA represents in all industries, not just tech. For example, the ability to use broad-based stock options are how Starbucks, FedEx, Outback Steakhouse, Gymboree, and Jet Blue to name a few, got off the ground. Even now that these companies are public they continue to believe that the use of broad-based employee stock options is essential to their success. These are the types of companies whose investors would be most harmed by disclosure of an unreliable number four times per year.

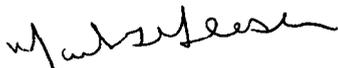
In short, disclosing a wrong number four times per year that is cloaked with the imprimatur of accuracy does no one any good. Providing investors with wrong numbers that they will then rely on makes no sense. The Board seems to have recognized this fact in connection with its recent decision to prohibit the use of mark-to-market accounting by energy traders. We believe that Chairman Herz was correct when he said “in order for [financial information] to be relevant, it has to be sufficiently reliable.” Energy Traders Feel the Effects of FASB Changes, Wall Street Journal, (October 28, 2002). The Board should not take any different stand when the issue is employee stock options.

Instead, the NVCA believes that the real “cost” of employee stock options is the potential dilution that could result to existing shareholder interests if the options are, in fact, exercised. We would fully support additional disclosures of information relating to dilution. These disclosures could take many forms. For example, there have been some concerns expressed that the use of the treasury stock method to compute diluted earnings per share understates the potential dilution of employee stock options. Perhaps the Board could consider requiring the type of super dilution figure that at least one commentator has called for. Business Week, News:Analysis & Commentary, September 23, 2002. In this way, investors would know what the true worst case dilution would be if all outstanding options were exercised. We also would support additional disclosures relating to stock options awarded to corporate executives. These types of reliable disclosures would provide investors with information that they need to make informed investment decisions.

Transition Rules

The Exposure Draft would allow those companies that choose to expense employee stock options to elect one of three transition rules. We believe that each of the rules raises its own set of issues, but, more importantly, any discussion of transitions rules puts the cart before the horse and is, therefore, inappropriate, and perhaps irresponsible, at this time. Rather than mandate new transition rules, we believe the Board should take a bold step and, instead, first focus on the real issue – the significant problems that exist with current valuation models and the expensing rules of FASB Statement No. 123. While the Board may discount our view of this issue because we do not believe that employee stock options should be expensed, even companies that have said they are going to adopt an expensing standard have raised significant issues with the current rules and valuation models and have asked for the Board’s help. These important issues should be addressed first – not after wholly unreliable and incorrect numbers have been reported in corporate financial statement and had an impact in our financial markets. Indeed, in light of the new certification requirements mandated by the Sarbanes-Oxley legislation and the turmoil in our financial markets, we think a more measured approach to this issue is the only prudent way for both the Board and companies that choose to expense their employee stock options to proceed.

Thank you for consideration of our views.



Sincerely,

Mark Heesen
President